Internal Revenue Service

memorandum

CC:TL-N-2926-87
TS: WILSON/raj

date: 2/27/87

to: District Counsel, Phoenix SW:PNX

from: Director, Tax Litigation Division CC:TL

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subject: Request for Technical Advice-Discharge of Indebtedness Income in Certain Computer Wrap Leasing Cases

This is in response to your undated memorandum request for technical advice on the above-referenced matter.

ISSUE

Whether installment payments by the seller on the non-recourse debt encumbering the computer in a typical computer wrap leasing case constitutes gross income to the purchaser?

CONCLUSION

Installment payments by the seller on the underlying non-recourse debt encumbering the computer do not constitute income to the purchaser in the typical computer wrap leasing case.

FACTS

Your memorandum describes a typical computer wrap leasing case in which a leasing company purchases a computer, paying for it with a non-recourse loan from a lender. The computer is simultaneously leased to a "blue chip" end-user lessee. A security interest in both the computer and the rentals is assigned to the lender. The rental payments are usually sufficient to amortize the debt.

The leasing company then sells the computer to an investor (subject to the underlying lease and the lender's security interest in the computer). The computer is then leased back to the leasing company by the investor. The investor generally pays for the equipment with a small amount of cash and a note to the leasing company. The rentals owed by the leasing company to the investor on the lease-back are calculated to amortize the note owed to the leasing company by the investor. Over the life of the transaction, the underlying debt to the lender is paid off

through the end-user lessee rentals. Likewise, over a longer term, the indebtedness due the selling leasing company is "paid off" by the investor through offset of the stated wrap lease rentals against the investor's note. The net result is that at the end of the lease term, the investor holds an unencumbered interest in the residual value of the computer.

ANALYSIS

Your memorandum suggests that the investor in a typical wrap lease must recognize discharge of indebtedness income when the underlying non-recourse debt is paid off through application of the end-user lessee's rental payments. The basis for that conclusion is that the non-recourse indebtedness owed to the lender is a debt of the investor for tax purposes since the investor purchased the equipment subject to that indebtedness. Crane v. Commissioner, 331 U.S. 1 (1947); I.R.C. § 108(d)(1)(B). As that debt is paid off, the investor is necessarily discharged from that indebtedness. As a result, discharge of indebtedness income should ordinarily be recognized by the investor. I.R.C. § 61(a)(12).

After reviewing your memorandum, we have concluded that the typical wrap lease does not give rise to discharge of indebtedness income. Our reason for that conclusion is that the underlying debt owed to the lender is not "discharged" or cancelled within the meaning of section 61(a)(12).

Income is realized under section 61(a)(12) when an indebtedness is discharged, forgiven or cancelled. Zappo v. Commissioner, 81 T.C. 77 (1983). In the typical wrap lease case, however, the underlying debt to the lender is satisfied in full (albeit with the rental payments by the end-user lessee rather than payments directly from the investor). Satisfaction of a debt in full does not give rise to discharge of indebtedness income. Waldheim v. Commissioner, 25 T.C. 839, 850 (1956). Although the taxpayer in Waldheim satisfied the debt directly rather than through someone making payments on her behalf, the fact remains that the debt was satisfied in full and not forgiven, cancelled or otherwise discharged by the lender. Thus, the underlying premise of the theory set forth in the memorandum, i.e., that there is a discharge of the indebtedness, is incorrect. Since there is no discharge of the indebtedness, there can be no discharge of indebtedness income to the investor.

Furthermore, there are other reasons we do not believe that the payment of the end-user lessee rentals to the lender in satisfaction of the debt constitutes income to the investor. To begin with, it must be kept in mind that the end-user lessee is

not the source of the loan payments for federal tax purposes. Although the end-user lessee pays its rental payments directly to the lender, that is merely because the lender was assigned a security interest in the rentals by the leasing company when it obtained the purchase money loan. For federal tax purposes, it is the same as if the end-user lessee had paid the rentals to the leasing company as sublessor who, in turn, paid them to the lender, in satisfaction of the debt. The leasing company/sublessor must report the rentals as income and is entitled to deductions for the interest paid on the debt. Thus, it is the leasing company/sublessor that is satisfying the debt rather than the end-user lessee.

We do not believe that the leasing company's satisfaction of its own obligations under the non-recourse loan constitutes income to the investor. The memorandum nevertheless infers that because the investor purchased the equipment from the leasing company "subject to" the non-recourse indebtedness, the debt constitutes a debt of the investor under the authority of Crane v. Commissioner, supra. Accordingly, it may be argued that payment of the investor's debt by the leasing company constitutes gross income to the investor. We do not agree. Crane does not teach that a purchaser of property encumbered by indebtedness becomes the debtor when, as in the typical computer wrap leasing case, the purchaser does not assume the debt of the original borrower or otherwise adjust the payment of the purchase price to reflect the debt. The theory underlying Crane is merely that a non-recourse loan must be treated as a true loan for federal income tax purposes. Commissioner v. Tufts, 461 U.S. 300 (1983).

In Tufts and Crane the focus of inquiry was on the seller of property encumbered by non-recourse debt rather than on the purchaser. It was held in both Tufts and Crane that the amount of non-recourse debt assumed by the purchaser in each case must be included in the seller's amount realized for purposes of computing gain on the sale. In so holding, the Supreme Court reasoned that,

> When encumbered property is sold or otherwise disposed of and the purchaser assumes the mortgage, the associated extinguishment of the mortgagor's obligation to repay is accounted for in the computation of the amount realized. See, United States v. Hendler, 303 U.S. 564, 566-567 (1938). Because no difference between recourse and non-recourse obligations is recognized in calculating basis, Crane teaches that the Commissioner may ignore the non-recourse nature of the obligation in determining the

> amount realized upon disposition of the encumbered property. He thus may include in the amount realized the amount of the non-recourse mortgage assumed by the purchaser. Commissioner v. Tufts, 461 at 308-309. (Emphasis added).

The preceding quotation from Tufts makes clear that the Crane analysis is aimed at cases where the purchaser assumes the obligation to make payments on the non-recourse debt. In the typical wrap leasing case, however, the investor generally does not "assume" any obligation of the selling leasing company to make payments on the non-recourse debt. In fact, it is contemplated by the terms of the transaction that the leasing company will continue to repay the non-recourse debt (through the assignment of rentals from the end-user lessee to the lender). As a result, the amount of the non-recourse debt is not taken into account in the payment of the purchase price and the investor is required to pay the whole fair market value of the equipment without reduction for the amount of the non-recourse debt encumbering the property.

The fact that the payment of the purchase price is not reduced by the amount of the nonrecourse debt distinguishes a purchase involving a wrap mortgage from purchases where the mortgage is "assumed" or where the property is purchased "subject to" a mortgage. Assumption of a mortgage means the buyer takes over the seller's obligation to the mortgagee and incurs an obligation generally enforceable by the mortgagee. Purchasing property "subject to" a mortgage means the buyer pays the seller only the difference between the purchase price and the mortgage debt. The buyer and seller agree that as between them the seller has no obligation to satisfy the mortgage debt which will be satisfied out of the property. See, Hunt v Commissioner, 80 T.C. 1126 (1983); Stonecrest v. Commissioner, 24 T.C. 659 (1955), nonacq. 1956-1 C.B.6, involving the computation of installment sale income under section 453 and its predecessor. See also Treas. Reg. § 15a.453-1(b)(3)(ii) which deems a wrapped indebtedness to be taken "subject to" an underlying mortgage debt for purposes of section 453, "even though the seller remains liable for payments on the wrapped indebtedness." This indicates that property is not taken "subject to" a wrapped indebtedness where the seller remains liable on the debt, in the absence of the deemed effect of the regulation.

As stated above, the investor in a typical computer wrap leasing case does not assume the underlying debt nor is the payment of the purchase price reduced by the amount of the non-recourse debt. Instead, the selling leasing company remains

liable for payments on the "wrapped indebtedness." Under these circumstances, we see no basis for concluding that the selling leasing company's payment of its own obligation's should somehow be imputed to the investor. See, Witherby, Whelan, Shorter, Fazio, Trumbull and Sturgess, Wraparound Lease Financing of Personal Property, 41 Bus. Law. 747, 753 (1986).

As the foregoing discussion illustrates, the payment of the non-recourse debt by the leasing company in a typical computer wrap leasing case is in satisfaction of its own obligation and not the obligation of the investor. This is because, contrary to the inference in the memorandum concerning the application of Crane, the non-recourse debt of the seller in a typical wrap leasing case does not become the debt of the investor where the terms of the sale require the seller to satisfy the debt.

Alternatively, even if the non-recourse debt could be said to follow the property and become the debt of the investor pursuant to Commissioner v. Tufts, supra and Crane v. Commissioner, supra, the result is the same. As part of the typical wrap leasing transaction, the selling leasing company agrees to make the payments on what is then the investor's non-recourse debt. This independent promise to pay the investor's non-recourse debt is given in exchange for the investor's agreement to pay the full amount of the purchase price without reduction for the amount of the non-recourse debt encumbering the property. In effect, the selling leasing company has incurred a new debt to the purchasing investor that is equal in amount to the non-recourse debt. The selling leasing company's payments on the non-recourse debt of the investor are, therefore, constructive payments of its own debt to the investor who is deemed to have used those payments to satisfy its own non-recourse debt.

Therefore, whether we view the non-recourse debt as that of the selling leasing company or that of the purchasing investor, the result is the same. In either case, the non-recourse debt is constructively satisfied by the appropriate debtor rather than by the end-user lessee. Although the result is the same under either analysis, we are forwarding a copy of this memorandum and your request to the Director, Interpretative Division, CC:I, for his views as to the correct analysis. We will advise you of those views when we receive them.

ROBERT P. RUWE

By: _____
R. ALAN LOCKYEAR
Senior Technician Reviewer
Tax Shelters Branch
Tax Litigation Division